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Whether or not my confidence is justified, I feel then, no serious doubt or hesitation what ever as to the causes of the world slump. I trace it wholly to the breakdown of investment throughout the world…I suggest to you, therefore, that the questions to which we have to bend our intelligences are the causes of the collapse of investment. We cannot hope either to prophesy or to limit the duration of the slump except as the result of our understanding of these phenomena.

John Maynard Keynes, *The Collected Writings*, *Volume XIII*, 1931

ECONOMIC SUICIDE

Pondering the past and future performance of economies and stock markets around the world, we distinguish between two different groups of countries — the high-savings countries of Continental Europe and Asia that are geared to rising investment and exports as their engines of economic growth, and the low-savings Anglo-Saxon countries that are geared to rising consumer borrowing as their engine of growth.

The first group has disappointed in the last few years with lackluster economic growth. While there are many differences between these countries, the protracted sluggishness of their economies has the same central cause, and that is a growing savings surplus. That is, investment spending and exports are no longer sufficient to absorb the flow of their domestic savings, hovering stubbornly around 10% of disposable income. The result is a chronic demand gap that keeps depressing their economic growth.

In contrast, the second group, the low-savings countries, has been excelling with rather lustrous economic growth. Actually, their investment spending is even weaker than in the high-savings countries, but in their case this has been more than offset in the past few years by extraordinary consumer borrowing and spending binges. Private household savings ratios in these countries fell on average by about five percentage points to 2–5% of disposable income. The manifest main propellant of the borrowing and spending binges were the wealth effects of booming stock markets that soared to unmatched heights. In essence, they are bubble economies.

There seems to be a general presumption that the economies of the low-savings group, though also slowing, will continue to outperform the other group. General attention in their case is essentially focused on the United States. In the case of the high-savings economies, it is focused in particular on Germany and Japan.

Our view in this question is radically different. As to the high-savings countries, we share the view that they will be stuck in a subpar growth channel for a long time to come. Investment and export growth will stay on the weak side, at best.

The crucial issue for the world economy, however, is not the development in Europe or in Japan, but what will happen to the U.S. economy, having flooded the rest of the world with an unimaginable excess of consumer demand that could not be met by the slowly rising domestic output.

According to the prevailing perception, the U.S. economy derives its far better growth performance primarily from a technological lead and superior flexibility and dynamism. True, measured by rates of real GDP growth, the United States has plainly outperformed most other countries in recent years. But we regard this gauge as too simplistic and misleading.

What really counts for an economy's inherent health and strength is not just GDP quantity but GDP quality, meaning the source and pattern of its growth. Truly healthy and sustainable growth is driven by the lure of attractive profits for capital investment. Both have been badly missing in the United States.

Comparing the economic development in the United States with that in the euro area and Japan, one single

difference has manifestly played the key role in boosting U.S. GDP growth, and that was the bubble-fuelled consumer borrowing and spending binge.

FORGET IRAQ

From what we read about the U.S. economy, we have to conclude that its enormous bubble-related, structural problems are still little understood. Too many economists in America possess an extraordinary ingenuity to discard the greatest imbalances in the economy as irrelevant. Record-high trade deficits, record-low savings and record-low profits do not matter in their eyes. It is by definition an economy that cannot have serious problems.

We like the statement that Rep. Bernard Sanders recently made to Fed Chairman Alan Greenspan after a testimony: *"Mr. Greenspan, I always enjoy your presentation because, frankly, I wonder what world you live in."* It is a question that we would like to ask numerous Wall Street economists and analysts.

Not only Mr. Greenspan, but most economists are clearly overstating the role of the Iraq jitters in slowing the economy. In the same vein, they flatly ignore the implications of the severe economic and financial maladjustments that the bubble-related borrowing and spending excesses have inflicted on the economy, among them in particular the profit implosion. There is no debate, no discussion, no questioning about this unprecedented profit calamity, just lamenting that increasing oil prices and the looming war with Iraq are causing companies and consumers to postpone big spending decisions. This explanation has, of course, the great virtue to make believe that the economy and the markets will resume booming as soon as this uncertainty is lifted, war or no war.

THE ESSENCE OF ECONOMIC HEALTH

For the great economic thinkers of the past, it was uniformly apodictic that healthy economic growth depends on three key attributes: a high share of saving, a high share of investment and a high share of profits. But the U.S. economy's strong growth during last year badly lacked all three attributes.

Looking for the effective quality of the U.S. economy's strong growth in recent years, we noted the following facts: In 2002, consumption accounted for 87% and government spending for 32% of GDP growth in current dollars. On the other hand, business fixed investment diminished GDP growth by 23.6%. Another sizable cut by 20.2% derived from the further worsening trade deficit. In the fourth quarter of 2002, by the way, government spending accounted for 39.4% of GDP growth. If this was a recovery, it was a very sick one that lacked everything for sustainability.

During the preceding four years, 1997–2001, nominal GDP grew altogether by $1,763.8 billion, or 21%. Consumption accounted for $1,457.7 billion, or 82.6%, of the total. That share was about 15 percentage points above the long-term average. Government spending provided $370 billion, or 20.9%. An unusually small contribution came from business fixed investment with $202.2 billion, or 11.4%, of the total. The soaring import surplus diverted a huge $259.6 billion of domestic spending abroad.

IT WAS CONSUMPTION-LED GROWTH

According to official interpretation and general perception, the U.S. economy's growth during these years was led by strong investment and productivity growth. The ugly reality was consumption-led growth as usual, with one important difference: this time the consumer borrowing binge went to an unprecedented extreme. Just as clear was its decisive propellant: the skyrocketing wealth effects of the booming stock market.

By definition, it is the essence of a bubble economy that rising asset prices fuel specific borrowing and spending excesses. In the case of Japan, these went mainly into commercial construction and business fixed investment. America's bubble economy had its decisive, big structural distortion in the borrowing and spending orgy of the consumer.

Consumption's steeply rising share in GDP was the manifest hallmark of the U.S. bubble economy that developed in the late 1990s. Essentially, a sharp rise in one GDP component implies the looting of other

components. In the U.S. case these victims were fixed investment and foreign trade.

THE FALSE ADJUSTMENTS

There is a widespread, hopeful view that the bubble-related imbalances and distortions are being rapidly corrected. In this view, the U.S. economy's main problem from the past boom years has been a protracted excess in business spending on fixed investment that has resulted in vastly excessive production capacity. Boosting potential supply in relation to slower demand growth, it is also supposed to be the main cause behind the profit carnage by destroying pricing power. From this perspective, the drastic retrenchment of business fixed investment represents a highly desirable correction of the prior investment excesses.

It is the consensus view. Yet it is absolutely ludicrous. Overinvestment may, indeed, be true for Asia but definitely not for the United States. As explained and documented, America's overwhelming structural maladjustment in the past few years has been bubble-driven overconsumption that plainly bombed out business investment and the trade balance.

What the slide in business fixed investment truly reflects from this perspective, our perspective, is not at all a desirable and necessary correction of a prior maladjustment but a dramatic worsening of chronic corporate underinvestment in the United States, its obvious cause being the profit carnage.

What obviously saved the U.S. economy from a crushing recession was the housing and mortgage refinancing bubble that developed with consumer debt growth beating record after record. In the third quarter of 2002, it ran at an annual rate of $770.7 billion, as against $661.3 billion in the same quarter a year ago, and $571.4 billion another year back.

Everybody is hailing this acceleration of the consumer borrowing binge because it has prevented a deeper recession. But in essence, this, too, represents an increasing maladjustment in consumer spending.

TWO TYPES OF WEALTH CREATION

As earlier remarked, the essence of a bubble economy is that the rising asset prices fuel extraordinary borrowing and spending excesses. It strikes us that American policymakers and economists have come to regard such plainly bubble-led economic growth as the new, normal pattern of growth.

Apparently, they believe that this is healthy, sustainable growth because the soaring consumer debts are counterbalanced by even bigger gains in consumer wealth through rising stock and house prices. It is another unbelievable fallacy in economic thinking.

It has been a truism for generations of economists that a nation's wealth consists exclusively in its income-creating, tangible capital stock piled up through saving and investing, and that new wealth creation implicitly consists exclusively in additions to this productive capital stock.

Never before has there been so much talk of wealth creation than in recent years. But it is no longer wealth creation through capital formation. It is wealth creation through rising market valuations of existing real or financial assets. Evidently, they are two fundamentally different kinds of wealth creation involving grossly different economic effects. But very few people seem to be aware of this difference.

Let us look at it. First of all, wealth creation through investment spending creates higher employment and incomes through the production of the capital goods. The emphasis here is upon its role in creating effective demand. When installed, the capital goods contribute to higher growth by adding to the economy's productive capacity. Most importantly, borrowing for investment is self-financing through the earnings that it creates.

Now compare these manifold economic effects of wealth creation through capital formation with the effects of wealth creation through booming stock and house prices. In terms of quantity, it has clearly been a fantastic success in the past few years. Running into many trillion dollars within barely five years, this wealth creation was infinitely greater than that through capital investment.

There is nothing like it in speed and quantity of wealth creation. But on closer look, it is wealth creation without any real substance. For the owners of these assets, it is a gain in their personal wealth. But the crucial point to see is that it lacks any direct effects inside the economy, in contrast to the manifold effects of wealth creation through capital investment. Any economic growth effect depends on the decision of the asset owners to realize a part of their capital gains for spending either through sale or through higher borrowing.

In the case of the United States, the wealth effects plainly boosted economic growth mainly through the resulting consumer borrowing and spending binges.

JUST PHANTOM WEALTH

Strikingly, it is the first time since economic thinking started that this kind of wealth creation through rising asset prices rather than through capital formation finds overwhelming attraction and admiration. The old economists never gave it any serious consideration. They flatly discarded it as pseudo or phantom wealth.

What the rising asset values effectively create is a corresponding rise in claims on the economy at the expense of those who do not own such assets. But this is wealth redistribution, not wealth creation. More importantly, this kind of wealth creation involves no gain in current incomes and productive capacity. To the extent that it actually boosts consumption at the expense of investment and the foreign trade balance, the net result from a macro perspective is overall impoverishment.

For the first time ever in the history of economic thinking, economists, that is, American economists, are claiming that growing asset prices represent fully valid wealth creation. In 1996, an article in *Foreign Policy* entitled *"Securities: The New Wealth Machine"* effectively explained that the financial markets have become the most powerful generator of wealth.

Verbatim: *"Historically, manufacturing, exporting, and direct investment produced prosperity through income creation. Wealth was created when a portion of income was diverted from consumption into investment in buildings, machinery and technological change. Societies accumulated wealth slowly over generations. Now, many societies, and indeed the entire world, have learned how to create wealth directly. The new approach requires that a state find ways to increase the market value of its stock of productive assets. Several countries have successfully directed their economic policies toward that goal, achieving and sustaining faster growth rates than were once thought possible…"*

Nowadays, wealth is created when the managers of a business enterprise give high priority to rewarding the shareholders and bondholders… In such a strategy, *"an economic policy that aims to achieve growth by wealth creation therefore does not attempt to increase the production of goods and services, except as a secondary objective."*

We wondered whether we should reprint such ridiculous economics. We choose to do it because this economic nonsense concisely reflects the confused thinking behind the new equity culture that has spread from America to the rest of the world. Economies exist for the securities markets. The markets, not the producers in the real economies, create the nation's wealth, and besides they do this much more efficiently in pleasing shareholders and nobody else.

One other consideration, above all, makes the transient and ephemeral character of the wealth "creation" through the markets poignantly clear, and that is the way it is calculated. Trillions of dollars of new wealth simply arise from the common practice to treat the value of the whole outstanding stock of assets as if they are worth the price of last trade which, as a rule, is of marginal size. It is like printing wealth.

RUINOUS EQUITY CULTURE

Indisputably, the new imperative to maximize shareholder value induced profound changes in corporate strategies. For better or worse, that is the question. Wall Street's propaganda machine, greatly assisted by confirmation through Mr. Greenspan, hammered into people's heads that in America *"unprecedented technological advances in high-tech technology and corporate governance had ushered in a New Era in which*

business were making unprecedented gains in productivity and profitability." Rapidly spreading belief in this nonsense kindled fantastic profit expectations that, in turn, helped kindle the steep rise in stock prices.

Realizing that the traditional process of profit creation through capital formation was much too tedious to satisfy the new, grossly inflated profit expectations in the market, corporations switched massively to new strategies that seemed to promise much quicker and higher returns. Thus, mergers, acquisitions, restructuring, downsizing, outsourcing, cost-cutting, stock buybacks and creative accounting became the main characteristics of the corporate strategies to expand.

While the consensus has been trumpeting a profit miracle, we have been protesting for years that this is impossible. What led us to this opposite conclusion were simple, compelling macroeconomic considerations. They say that there is ultimately but one single way for businesses to increase their profits in the aggregate, and that is by mutually increasing their revenues through higher investment spending. With this rule in mind, we realized that all those new corporate strategies meant to boost profit creation when taken together could only have the opposite effect of depressing profits.

In fact, at the height of the boom, executives and firms faced sharply falling profits, while the prices of their shares, reflecting the inflated profit expectations, were soaring. Most importantly, Mr. Greenspan eagerly supported the stock market boom not only with absurdly euphoric statements, but also with record-high money and credit creation.

Confronted with tremendous pressure from the markets to meet the grossly inflated profit expectations, the great corporate account rigging developed for a straightforward reason. It was the need and desire to cover up the increasingly desperate corporate profits picture, contrasting dramatically with the former high-riding promises. Manifestly, the unfolding epidemic of accounting frauds is not just bearing witness to an unprecedented high level of greed. The far more important aspect is its deeper cause: the horrible reality of Corporate America's worst profit performance in the whole postwar period.

Measured as a share of GDP, profits today are at their lowest level in the whole postwar period. During the last year of the boom, in 2000, before-tax profits of nonfinancial firms were equivalent to 4.3% of GDP. That was down from 6% of GDP in 1997. This plunge of profits has to be seen against the backdrop of 18% GDP growth during this period. More recently, profits are down further to 3% of GDP. What has hammered the stock market is plainly not a lack of confidence but collapsing profits.

A JOBLESS AND PROFITLESS RECOVERY

One thing above all ought to be clearly understood: Without a profits renaissance, the U.S. economy's downturn can only worsen. For good reasons highly positive profit forecasts abound. Unfortunately, the authors regularly keep silent about their underlying assumptions. Yet the general considerations behind these optimistic forecasts are well known. It is the widespread conviction that the massive, combined monetary and fiscal stimulus being applied cannot fail to restore stronger demand growth.

Meanwhile, it appears to be generally understood that without a pronounced profit renaissance, the economy's downturn is bound to worsen. In the consensus view, American corporations are making new, strenuous efforts to boost their profits by a new round of ferocious cost-cutting. It is obviously a main consideration behind Wall Street's optimistic profit forecasts.

For an answer, we can only repeat what we have said many times before: This method of profit creation can only fail. As we have always stressed, this high appreciation of corporate cost-cutting as the golden road to prosperity is grossly misplaced. It may boost the profits of some firms, but it infallibly squeezes profits in the aggregate when practiced by most firms because one firm's expenses are always another firm's revenues.

WHAT PRODUCTIVITY MIRACLE?

In the end, all questions about the U.S. economy's prospects lead to the one question of the actual causes behind its unprecedented and unusual profit depression. Pondering those causes, it has been puzzling us for a

long time why this horrible profit performance oddly coincides with simultaneously reported stellar productivity growth. With inflation rates still between 1–2%, profits, too, ought to be strong.

For a long time, this flagrant contradiction between the performances of the two has been reason enough for us to question the reliability of the productivity numbers. An additional highly critical consideration in this respect has always been that a country where consumption soars as a share of GDP is not at all prone to deliver a productivity miracle.

In actual fact, in the postwar period Europe and Japan have almost permanently had considerably higher productivity growth than the U.S. economy. This changed for the first time rather abruptly in 1995. While productivity growth in Europe slowed, that of the U.S. economy shot upward. The general explanation is that this sudden jump in the United States was due to a big spurt of efficiency through innovation, investment in information technology, better corporate governance and deregulation.

In actual fact, annual business sector productivity growth in the United States has averaged 2.8% since then, far higher than the 1.7% in the prior 25 years. During the 1960s, though, it had been above 3%.

Assessing productivity growth, the first thing to realize is that one single percentage point makes all the difference between mediocre and miraculous performance. The second thing to realize is that there are giant measurement issues. In the United States, labor productivity growth is calculated by dividing the growth in nominal GDP by a price index and an estimate of hours worked. Clearly, even the smallest measurement errors in these three variables weigh heavily in comparison to the rate of productivity growth where one percentage point more or less makes all the difference.

An obvious, most dubious, component in the American productivity equation is the measure of hours worked. In reality, there is no way for serious measurement. That is why the rest of the world measures per worker. Recently the Bundesbank reported that German productivity growth, if measured the American way, would have been 2% in the past few years, rather than 1.4%.

LIES, DAMNED LIES AND STATISTICS

When assessing and comparing reported productivity growth, a key point to keep in mind is that whatever increases real GDP implicitly increases productivity growth by the same rate. In the past few years, the U.S. government's statisticians have made great efforts to improve their measurement methods. Together, the resulting improvements had the effect of substantially adding to real GDP growth, which, of course, correspondingly bolstered productivity growth.

Actually, much of the gains in reported GDP and productivity growth versus the past and also versus other countries comes from these statistical changes that are unique to the United States. In their absence, productivity growth may well have deteriorated. In the following, we describe and measure these effects where possible.

Altogether, we identify four such effects: first, in 1997 a major downward adjustment of the price indexes on account of quality improvements; second, so-called hedonic pricing of computers; third, recognition of business expenditures on software as investment in 1999; and fourth, disproportionate increases in depreciation charges due to increasingly short-lived investment.

(1) Quality adjustments. In 1997, a commission appointed by the Senate Finance Committee published a report which stated that America's consumer price index computed by the Bureau of Labor Statistics overstated the reported inflation rate by 1.1 percentage points. This tacitly implied that real GDP and productivity growth were understated by this rate.

The main contention of the Boskin report — named for its chairman, Michael Boskin, who had served as chief economic advisor to former President George Bush — was that the statistical experts vastly failed to take quality improvements of many products into account.

It has been reported that the statisticians of the Labor Department effectively implemented most of the

recommended adjustments, essentially with commensurate boosts to reported real GDP and productivity growth. The basic idea behind these adjustments is that such an index should not simply measure price changes but changes in the “standard of living” or in “consumer satisfaction.”

Meanwhile, a study undertaken by a panel of 13 economists led by Charles Schultze of the Brookings Institution, partly commissioned by the Bureau of Labor Statistics, has raised serious questions about the accuracy of the estimates for quality adjustments. Without going into exact figures, the panel concluded that such a price index is inherently too ambiguous to be practiced in an objective way.

It has been reported that the applied quality adjustments actually reduced the measured annual inflation rate by 0.8%. If so, this means an equivalent rise in real GDP and correspondingly to productivity growth. We have no confirmation, but it is undisputed that the resulting downward adjustments in the inflation rate were quite substantial.

(2) Hedonic pricing of computers. During the boom years 1997–2000, U.S. businesses actually increased their spending in current dollars on computers from $79.6 billion to $93.3 billion, that is, by a mere $13.7 billion. But in the real GDP accounts, the same spending appears with an increase from $102.9 billion to $246.4 billion, or $143.5 billion, actually more than 10 times the amount in current dollars. The difference of $129.8 billion between the two measures effectively accounts for 12.5% of the recorded real GDP growth during this period.

This practice of measuring computer investment goes back to 1986. After long debate, the government statisticians decided to measure their output from then on in a new way. The idea was to capture rising computer power, and the statistical result was sharply declining computer prices, not in the market but in the GDP accounts.

Until 1995, this change in measurement made no spectacular difference to the figures. A rapidly growing divergence to prices in current dollars only emerged after 1995. Registering rapidly rising computer power, the statisticians slashed computer prices by 30% and more per year, and by doing so, they recorded correspondingly big additions to business investment, real GDP and productivity growth.

(3) Recognition of software spending as business investment. The decision for this change was made in 1999. It implied to no longer treat business spending on software as an expense, but as investment. Since few people understood its statistical implications, it found very little interest.

Its actual implication was to boost the measured real GDP and productivity growth. The crucial point is that GDP only measures the final product. For the business sector this means that only its capital spending enters GDP. All its expenses on intermediate goods, running into trillions of dollars, are left out of account. Shifting spending on software from expenses to investment gave real GDP and productivity growth another push.

In 1998, the year before this change, business investment in the new information technology had been running at $233.3, after $206.6 billion in the year before. The new treatment of software boosted the 1998 amount to $356.9 billion and that of 1999 to $407.2 billion. The increases recorded in the following years, between 1997–2000, amounted to $62.9 billion, accounting for 6% of GDP and productivity growth during this period.

(4) Disproportionate rise in depreciation charges. Yet there is one big exception to this rule of disregarding business expenses in the calculation of GDP. That is depreciation charges on capital investment — therefore the term *gross* domestic product. Although depreciation charges, too, are business expenses, they are counted as additions to GDP. This, too, has important consequences.

One of the particularities of the U.S. economy’s growth performance in recent years has been a drastic shift in its investment pattern toward very short-lived equipment, above all computer hardware and software. As the rate of obsolescence accelerates, a growing chunk of business investment spending serves simply to replace capital that is wearing out. Economic reason says that this should not be counted as a productivity gain.

Gross investment, too, has beneficial effects due to technological improvement. But from a macro perspective, net investment is the decisive component in investment spending. It alone adds to the economy’s capital stock, and it alone adds to aggregate profits because depreciation charges are business expenses.

Therefore, the difference between gross and net is most important.

In 2001, gross business fixed investment of $1,201.6 billion compared with net investment of $268.1 billion. Thus, it took about 4.4 dollars of gross capital spending to yield a 1 dollar net addition to the capital stock. Historically, this is the highest ratio ever. The problem lies in the opposite effects on profits. Profit-boosting net investment is plummeting, while profit-depressing depreciation charges, related to past investment, are soaring. We think this pinpoints one major reason for bad profit prospects.

As earlier mentioned, whatever adds to real GDP adds equally to productivity growth.

As depreciation charges accelerate due to the increasing share of very short-lived investment, it also boosts real GDP and productivity growth. Between 1990–95, depreciation charges on equipment rose by 31%, between 1995–2001 by 51%, compared with GDP growth of 26% and 36% during the two periods.

PRODUCTIVITY MIRAGE

In fact, we have never believed that Corporate America's profit and productivity miracles, as trumpeted in the past years, could be a reality or ever come true. What strictly determined our very critical view right from the beginning were plain macroeconomic considerations that used to be truisms for the elder economists.

According to macroeconomics, both profit and productivity growth have their main driver in capital formation. That, though, happens to be the weakest component in the U.S. economy. It always has been. Its performance in saving and investment during the whole postwar period has been one of the poorest among industrial countries. But in the last 20 it was at its worst.

It was straightforward macroeconomic analysis that led us very early to the conclusion that America's new equity culture, with its new strategies for near-term maximization of shareholder value, was in essence destructive for capital formation and thereby also destructive for profit and productivity growth. What these policies maximized was financial engineering and consumption at the expense of capital formation.

As to corporate profits, their disastrous performance is well documented. In contrast, the alleged productivity miracle continues to be implored as conclusive proof that the New Economy nevertheless exists. The same reason that led us to denounce the possibility of a profit miracle has been leading us to denounce the possibility of a productivity miracle: grossly lacking capital formation.

As explained, the strong U.S. productivity gains recorded in the past few years have heavily benefited from changes and existing differences in statistical measurement that are unique to the United States. Taking them all into account, U.S. productivity growth is barely superior to that of the other major industrial countries. It may be inferior. The most striking proof is the disastrous profit performance that started at the height of the boom.

Those changes in statistical procedures were undertaken with the declared, apparently plausible, intent to improve measurements. Yet in reality they have deluded and confused simply because too few people understand the statistical subtleties.

As to the hedonic pricing of computers, the idea of measuring them in terms of their rapidly rising power, may appear quite reasonable from a technological perspective. Yet from a strictly economic perspective, it doesn't make any sense. It starts with the absurdity that the mere act of buying a computer instantly inflates measured output and productivity by a tenfold amount because of the big negative deflator. Most absurdly, all these dollars created through hedonic pricing are for businesses pure fiction. Their costs and profits directing all their production and investment decisions are determined by current dollars.

From the very important profit perspective, in other words, hedonic pricing is pure smoke and mirrors, and the same is true for economic analysis. Here is what happened in 2002: Measured from fourth quarter to fourth quarter in current dollars, business spending on computers increased minimally from $69.3 billion to $75.4 billion, after a peak of $93.3 billion in the third quarter of 2000. But measured in hedonic dollars, this same spending ballooned from $243.3 billion to $303.1 billion. With real GDP up overall by $270 billion, more than one-fifth of it came from hedonic computer pricing, of course with a commensurate, positive effect on

productivity growth.

Judging by the current-dollar numbers, tech spending remains manifestly in the doldrums. But for the bullish consensus, who focus exclusively and stereotypically on changes in real GDP, tech spending underwent a steep rise last year that they herald as the possible beginning of an investment-led recovery, which everybody is hoping for.

CORPORATE SELF-DESTRUCTION

Assessing the U.S. economy's prospects, it is most important to realize in the first place the tremendous damages that the new corporate strategies have effectively inflicted on its whole warp and woof in the obsessive pursuit of quick profits and shareholder value maximization. Instead of investing in the future, consumers and businesses have ferociously borrowed from the future.

At the heart of America's new equity culture was the acquisition and merger boom, shattering record after record. From 1998 through 2000, U.S. corporations completed nearly $4 trillion worth of mergers — more than in the preceding 30 years. Obsessive eagerness to buy growth and profits led the acquirers to pay prices vastly above market values that, in turn, were vastly in excess of book values.

The general public's justification for the developing merger mania was the claim of grand synergies that would be achieved through possible major cost-cutting. In general, these never materialized. Most important for the actors were in reality the inherent possibilities to delude investors about profit prospects.

A company with a high price-earnings valuation clearly juices its short-run earnings by buying other companies with lower price-earnings valuations. Yet the greatest attraction for the CEOs of the acquiring firms, with their stock options in mind, was certainly the general practice to capitalize the deal costs, generally gigantic, in their balance sheets as goodwill, while any profits promptly went into the company's income statement. Goodwill was quietly expensed over a period as long as 40 years.

From a strictly economic perspective, this was all plainly insane. But who cared? A new regulation, compelling corporations to write down goodwill in line with the market prices of their shareholdings, is now playing havoc with balance sheets by triggering numerous, huge write-offs. Finally, the ugly reality is being revealed. Thousands of firms have malinvested trillions of dollars into worthless goodwill.

As a result, today's balance sheets of nonfinancial corporations look more like the balance sheets of hedge funds. Between 1997 and the third quarter of 2002, they have increased their stock of equipment and software at replacement costs by $452 billion, or 17%, and their real estate stock at market value by $750 billion, or 18%. On the other side of their balance sheets, indebtedness ballooned by $3,108 billion, or 47%.

The single biggest growth component on the asset side of balance sheets with an overall rise of $2,539 billion, or 70%, were "miscellaneous assets," among them the ominous goodwill. Nonfinancial corporate net worth is up during this period by $1,613 billion. But this includes the big chunk of worthless goodwill on the asset side. Leaving that out of account, corporate net worth has suffered a major decline.

One increasingly unpalatable, longer-term consequence of the steeply rising mountain of unproductive corporate debt was always foreseeable: a soaring interest bill savagely squeezing profits. For manufacturing, the interest bill has almost doubled from $44.9 billion to $81.4 billion between 1997–2001, while profits have more than halved from $195.2 billion to $83.4 billion. In the case of transportation and utilities, the interest bill soared from $46.4 billion to $76.1 billion, while profits collapsed from $85 billion to $27.7 billion.

Drastic cuts in corporate investment and furious refinancing of existing debts at lower rates point to a sharply slower rise in interest expenses. Yet profits remain caught in the vice of other, far stronger, depressing influences. One is a literal collapse in retained earnings, as firms are raising dividend payments in the face of sliding profits. Another intensifying squeeze arises from escalating depreciation charges due to the sharply higher share of short-lived investment. On average, these charges increased at an annual rate of $62.3 billion between 1995–2000, as against $27.4 billion in the first half of the decade.

MACRO DESTRUCTION

But what, after all, decisively clinches our dismal expectations for the U.S. economy's growth and profit prospects are macroeconomic considerations. They focus on the causes and implications of the poor performance in capital spending and foreign trade.

Most American economists, typically, completely ignore both influences because they fail to see their massive damaging effect on business profits. The one single exception that we know of is the Levy Institute, and for this reason, they, too, are singularly negative about profit prospects.

We are sorry to repeat ourselves, but understanding the U.S. economy's protracted profit implosion requires a clear recognition of the decisive role that the massacre of these two macroeconomic aggregates play in this respect.

It starts with the truism that business profits are equal to the difference between overall revenues and overall expenses. But what exactly determines that difference? That is really the key question about economic growth. In the consensus view, the main determinants of profit growth are productivity growth, lowering expenses and the inflation rate.

In Bob Woodward's *Maestro*, the book about Mr. Greenspan, one brief episode struck us as typical of the thinking of most American economists. Expressing surprise that profits were strongly rising in the face of very low inflation rates and booming investment, Mr. Greenspan drew the conclusion that productivity growth must be understated.

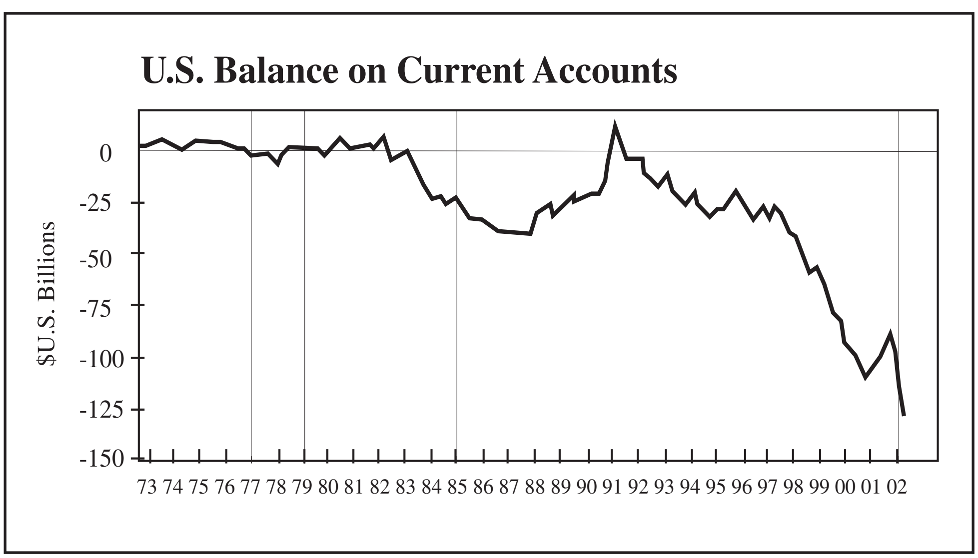
Obviously he failed to see — and probably still fails to see — that business fixed investment is typically the most important profit source in the capitalist economy. Looking at the business sector as a whole, investment spending creates business revenues, just like consumer spending. But its particular importance for profit creation arises from the fact that it creates revenue without immediate expense. But this applies only to investment in excess of depreciation charges; that is, to net investment.

This is because the investing firms capitalize this part of their investment spending in their balance sheets. The expenses, entering the profit-and-loss account, follow gradually with the depreciation charges.

Net fixed investment is a very small component in the U.S. GDP. It hit its postwar peak in the 1960s with almost 7% of GDP. Since then, it has been down, though with sharp swings. The longest and steepest decline occurred in the 1980s, hitting a low of 2.8% of GDP. This was followed by a sharp recovery in the 1990s up to 4.1% of GDP in 2000, but followed again by literal collapse. The bottom line is that the nonfinancial corporate sector's capital stock, measured in current dollars, has declined over the past 20 years to its lowest level as a share of GDP.

THE DOLLAR THREAT

Pondering the various dangers looming in the U.S. economy and its financial system, we focus on the gargantuan deficit in the current account of the balance of payments, presently running at an annual rate of about $500 billion, after $128.4 billion in 1997. Pointing to the huge capital inflows that have financed this deficit, the American consensus discards it as a non-problem.



In our view, it is among America's biggest problems, and definitely the most dangerous one for the United States and the whole world because the relationship to the capital inflows determines the price of the dollar. Expecting miraculous investment returns from America's New Economy, foreign firms and investors have poured trillions of dollars into U.S. stocks and bonds since 1995. Plainly, they played an important role in fueling the financial boom. It was even enough to drive the dollar up despite the huge dollar outflow through the rapidly widening current account gap.

It turns out that these investments have in general been the greatest malinvestment in history. What the foreigners effectively bought into was America's worst profit carnage. Not surprisingly, capital inflows from Europe have sharply slowed. They also slowed in Asia as far as private flows are concerned, but the central banks stepped in with massive dollar purchases of their own, about $137 billion over the last 12 months, preventing the dollar from declining against their currencies.

Looking at the sharply worsening economic conditions in the United States, it should be clear that its attractiveness for foreign investors is slumping, putting the dollar increasingly into jeopardy. What makes the outlook particularly frightening is the simultaneous surge in the trade deficit, actually running completely out of control. The reported December deficit was up an eye-opening 62% year-over-year.

Compared to year-ago levels, December goods imports were up 20% to $103.9 billion, while exports inched up 1% to $55.6 billion. Exports paid for just 53.5% of imports. A recent comment from Treasury Secretary John Snow: *"At the current levels of the current account deficit, I'm not particularly troubled by it… It is really a small part of the size of the total U.S. and is certainly manageable."*

In order to realize the immense dangers looming in the monstrous trade deficit both for the economy and the dollar, it is first of all necessary to understand its internal destructive effects on income and profit growth. Basically, it reflects the excess of domestic spending over domestic production and available current incomes. For the American consensus, the trade deficit is no problem because the spending excess is offset by the capital inflows. Indeed, these flows do offset it, but only in the balance of payment, not in the associated domestic income compression.

The crucial internal effect is that the spending for the import surplus essentially diverts revenue and profit to foreign producers. On the other hand, the money being spent abroad comes largely from income that has been earned from domestic producers. The end result: these have the costs, while foreign producers have the revenue and the profit. This is the widely unrecognized big problem implicit to the monstrous trade deficit.

Mr. Snow argued recently, *"the deficit is small in comparison with the big GDP."* Looking for effects on current income and profit growth, we compare the deficit with the simultaneous increase in national income. What we see is terrifying. U.S. national income rose by $137.6 billion in 2001 and by $515.7 billion in 2000. An annual trade deficit of close to $500 billion clearly plays havoc with domestic income creation. The domestic income circulation is bleeding out to foreign producers. What the capital inflows effectively create is soaring foreign indebtedness.

Unconcerned as always, the consensus expects a limited dollar devaluation will solve the problem by decelerating imports and accelerating exports, thereby assuring, after all, the U.S. economy's soft landing. In our opinion, the U.S. economy's structural problems are far more complex than this view presumes. But it cannot seriously be assumed that the surge of the trade deficit in the past few years had its main cause in the rising dollar.

Manifestly, there were two far more important causes at play. The one was unbridled money and credit creation, sending U.S. consumer demand into orbit; and the other one was grossly lacking capital investment in manufacturing on the supply side. This lasted long enough to impact the resource allocation in the economy. Consumption-oriented investment boomed at the expense of the capital goods and export industries. Reducing the monstrous trade deficit again inexorably requires a difficult and painful reversal of this resource shift.

Even with a rapid fall of the dollar, further large deficits are bound to be incurred and will have to be

financed. Expecting a further worsening of economic conditions in the United States and a lot more of the same bear market in stocks, a miracle is needed to prevent a steep slide of the dollar. The two questions to ponder now are first, the speed and extent of its slump; and second, its effects on the financial markets.

It appears comforting that the dollar's steep fall in the 1980s caused no visible strain in the American financial markets, except for the brief stock market crash in 1987. But the two periods grossly differ in crucial ways. First of all, today's deficit in the current account is far higher; second, foreign purchases and holdings of U.S. stocks played virtually no role in the '80s. The holdings were minimal, and the soaring trade deficit was overwhelmingly bank-financed. Today, foreign holdings of U.S. stocks are astronomical, amounting to trillions of dollars, and foreign stock purchases played a key role in financing the U.S. deficit.

CONCLUSIONS:

If the dollar's sharp fall against the euro, meanwhile by 28%, has taken most people by surprise, our great surprise is how little worry there really prevails among economists and in the markets about a further long, steep fall. We have no doubt about its underlying main reason: longer-run expectations about the U.S. economy, its stock market and the dollar remain quite bullish in comparison with such expectations about the euro zone and Japan.

In this letter, we have scrupulously analyzed and described the micro- and macroeconomic ravage of the U.S. economy and its corporate sector through credit and debt excesses that are unprecedented in history. The highly visible legacy is a carnage of profits, national saving, net investment and exports.

To correct these massive maladjustments on the economy's supply side would take years. But what we see are only policies that prolong and worsen this macro- and microeconomic carnage through more and more consumption.

In due time, the dollar's decline will turn into a rout, playing havoc both with the U.S. bond and stock market.

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